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# Corporations -- Recovery of Indemnity by Passively Negligent Directors

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fulcrum of the plaintiff's discomfort. The charges against Esteban and Robards did not even refer to the regulations."<sup>70</sup> It is somewhat disturbing to find that an individual can be deprived of a college education on the basis of vague rules, but it is much more upsetting to discover that he may be deprived of it on the basis of some previously undefined common law rule governing the behavior of students. The federal and state courts have written numerous opinions concerning the procedural rules to be applied in college disciplinary proceedings; it is clear that they are concerned that students not be arbitrarily denied the advantages of a public college education. However, unfairness may not be purged from student disciplinary action without the strict application of accepted constitutional standards to the substantive rules. Professor Wright was very close to the heart of the matter when he said:

If rules of this generality are permissible then students have gained something, but not very much, from the decisions requiring procedural safeguards to be observed. It will do a student very little good to be given every protection of procedural due process ever thought of anywhere if, in the end, he may be expelled because the tribunal is free to apply a subjective judgment about what is acceptable conduct. This would be neither fair nor reasonable.<sup>71</sup>

J. CLINTON EUDY

### Corporations—Recovery of Indemnity by Passively Negligent Directors

The exact nature of the legal relationship of corporate directors to the corporation or its stockholders has long been a source of much confusion. Various legal theories have been developed:

The position of directors has been variously designated and described. Thus, they have been called agents; and they certainly are for some purposes agents of the corporation. They have also been called "managing partners;" but as they are obviously not partners at all, the phrase is helpful only by analogy. Again, they have been called "trustees." But a trustee is one who holds the title to property for the benefit of another, and as directors are not invested with the title to corporate property, the inaccuracy of the appellation is apparent. The truth is that the status of director and corporation is a

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<sup>70</sup> 415 F.2d at 1088.

<sup>71</sup> Wright, *The Constitution on Campus*, 22 VAND. L. REV. 1027, 1065 (1969).

distinct legal relationship. It resembles in some respects those of agent and principal, of managing and dormant partners, of trustee and *cestui que trust*; but it is different from each.<sup>1</sup>

In *DePinto v. Landoe*<sup>2</sup> the Court of Appeals for the Ninth Circuit applied alternate legal theories to the issue of whether a passively negligent corporate director could recover indemnity from a director who is guilty of malfeasance.

In *Landoe*, the plaintiff and two of the defendants were directors of United Security Life Insurance Co. (United).<sup>3</sup> When United was in the twilight of its productive life, the defendants formed American Security Investment Co. and transferred 314,794.19 dollars of United's assets (consisting of cash, promissory notes, and mortgages)<sup>4</sup> to American in exchange for worthless American stock.<sup>5</sup> At the same meeting in which the defendants voted to authorize transfer of United's assets, DePinto was present only to offer his resignation from the board of United prior to the vote.<sup>6</sup> In a derivative suit<sup>7</sup> brought by United's stockholders, the claim against DePinto was severed<sup>8</sup> from the claims against the other directors. Judgment for the value of the transferred assets was entered against him. In *DePinto v. Provident Security Life Insurance Co.*,<sup>9</sup> the Ninth Circuit found sufficient evidence to support a finding of negligence and breach of fiduciary duty by DePinto and affirmed the judgment against him. DePinto's cross-complaint against his fellow directors for the amount of the judgment was dismissed by the district court,<sup>10</sup> and the appeal in *Landoe* followed.

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<sup>1</sup> 2 A. MACHEN, A TREATISE ON THE MODERN LAW OF CORPORATIONS § 1399 (1908).

<sup>2</sup> 411 F.2d 297 (9th Cir. 1969).

<sup>3</sup> Of the three defendants, Sabo and Pegram were directors of United, and Landoe was a director of American Security Development Co. The claim against Sabo and Pegram arose out of their alleged breach of fiduciary duty. The claim against Landoe was grounded in conspiracy to commit fraud; it is peripheral to this note and will not be considered further.

<sup>4</sup> *DePinto v. Provident Security Life Ins. Co.*, 374 F.2d 37, 47 n.7 (9th Cir. 1967).

<sup>5</sup> *Id.* at 43.

<sup>6</sup> *Id.* at 42.

<sup>7</sup> *DePinto v. Provident Security Life Ins. Co.*, 374 F.2d 37 (9th Cir. 1967).

<sup>8</sup> The claim against DePinto was severed because it was uncomplicated by allegations of fraudulent transfer. The claim against him was based solely on his alleged failure to exercise the required standard of fiduciary care.

<sup>9</sup> 374 F.2d 37 (9th Cir. 1967). For the fifteen months prior to the final meeting of the board, DePinto attended none of the board meetings but perfunctorily signed the minutes of those meetings. Twice during the period, he signed minutes stating falsely that he was present. *Id.* at 41.

<sup>10</sup> *DePinto v. Landoe*, 411 F.2d 297, 299 (9th Cir. 1969).

The Ninth Circuit in *Landoe* based the first of its alternative theories on analogy to the law of trusts to reach the conclusion that DePinto could recover indemnity from his fellow directors. Concluding that Arizona law, which accepted the analogy, controlled,<sup>11</sup> the court held that DePinto's right to obtain indemnity arose out of his "consensual relationship"<sup>12</sup> with the corporation. He therefore became subrogated to the claims of United against his co-directors.

Although in a number of cases courts have designated corporate directors as "trustees" either for the corporation or for its stockholders,<sup>13</sup> analogy to the law of trusts is not without conceptual difficulties. A trustee holds title to the trust property;<sup>14</sup> a corporate director does not hold title to the assets of the corporation. Beneficiaries of a trust are liable to third persons for costs incurred in administration of the trust;<sup>15</sup> stockholders of a corporation are not personally liable for operating expenses of the corporation. It must be concluded, therefore, that directors of corporations should be treated as constructive trustees<sup>16</sup> or as trustees for limited purposes<sup>17</sup> only when some policy of the law justifies such treatment. In deciding *Landoe*, however, the court failed to evaluate the policies that would justify indemnifying the director who was passively negligent.<sup>18</sup>

The court in *Landoe* could have based its decision solely on the analogy that it found to the law of trusts. However, analyzing the case in terms of agency, the court found an alternative theory for allowing recovery of indemnity.<sup>19</sup> Under the second theory used by the court,

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<sup>11</sup> *Id.* at 300, *citing* *Kenton v. Wood*, 56 Ariz. 325, 107 P.2d 380 (1940); *Steinfeld v. Neilson*, 15 Ariz. 424, 139 P. 879 (1913); *Hatch v. Emery*, 1 Ariz. App. 142, 400 P.2d 349 (1965).

<sup>12</sup> 411 F.2d at 300.

<sup>13</sup> *Cf. Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941); *Saracco Tank & Welding Co. v. Platz*, 65 Cal. App. 2d 306, 150 P.2d 918 (1944); *Tuttle v. Junior Bldg. Corp.*, 228 N.C. 507, 46 S.E.2d 313 (1948). *Contra*, RESTATEMENT (SECOND) OF TRUSTS § 16A (1959).

<sup>14</sup> RESTATEMENT (SECOND) OF TRUSTS § 2 (1959).

<sup>15</sup> *Id.* § 274.

<sup>16</sup> *Bainbridge v. Stoner*, 16 Cal. 2d 423, 429, 106 P.2d 423, 427 (1940).

<sup>17</sup> "[Corporate directors are] trustees in the sense that every agent is a trustee for his principal, and bound to exercise diligence and good faith." *Wallace v. Lincoln Sav. Bank*, 89 Tenn. 630, 649, 15 S.W. 448, 453 (1891). "One who is a director for a corporation acts in a fiduciary capacity, and the law does not allow him to secure any personal advantage as against the corporation or its stockholders." *Bainbridge v. Stoner*, 16 Cal. 2d 423, 427, 106 P.2d 423, 426 (1940).

<sup>18</sup> See p. 960 *infra*.

<sup>19</sup> However, if we are mistaken in this analysis [analogy to the law of trusts], and DePinto should, under Arizona law, be regarded as a tort-feasor with respect to the breach of his fiduciary duty, we are nevertheless of the

DePinto was treated as an agent of the corporation, and his breach of fiduciary duty brought about his liability in tort.<sup>20</sup> The court allowed him to recover indemnity because it held that the breach of his duty had been passive in nature while the defendants had been guilty of malfeasance.

The use of the theory of agency in the case is as plagued by conceptual difficulties as is the analogy to the law of trusts.<sup>21</sup> A true agent, unlike a corporate director, acts on behalf of and subject to the control of his principal at all times.<sup>22</sup> Furthermore, either party can terminate the agency relationship at any time.<sup>23</sup> Analyzing the case in terms of agency also raises two other difficult problems. A principal as the plaintiff in a tort action against an agent must prove an actual monetary loss to recover damages,<sup>24</sup> and he must prove that the loss was the proximate result of the defendant's breach of a fiduciary duty.<sup>25</sup>

Although DePinto had violated his fiduciary duty to United,<sup>26</sup> the court in *Landoe* found that his actions had been "inactive in nature, different in character, and prior in time"<sup>27</sup> to those of the defendants and that he could, therefore, properly cross-complain for indemnity. Cited as controlling on the issue of indemnity was *Busy Bee Buffet, Inc. v.*

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view that, under the particular circumstances of the case, his status as a tort-feasor does not bar him from obtaining indemnity.

411 F.2d at 300.

<sup>20</sup> *Accord*, *Baltimore & O.R.R. v. Foar*, 84 F.2d 67 (7th Cir. 1936); *Etheredge v. Barrow*, 102 So. 2d 660 (Fla. Dist. Ct. App. 1958).

<sup>21</sup> RESTATEMENT (SECOND) OF AGENCY § 14C (1958): "Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members."

<sup>22</sup> *Id.* § 1. A board of directors is not subject to stockholders' control except with regard to the appointment and removal of its members. The stockholders cannot otherwise interfere, and the board of directors is entitled to use its own business judgment in managing the affairs of the corporation. *Id.* § 14C, comment a; Note, *Position of Corporate Director as Sui Generis*, 35 MINN. L. REV. 564, 565-66 (1951).

<sup>23</sup> RESTATEMENT (SECOND) OF AGENCY § 119 (1958). Except under certain extreme circumstances, members of a corporate board of directors can be displaced only by the stockholders' refusal to re-elect them. *Id.* § 14C, comment a; Note, *Position of Corporate Director as Sui Generis*, *supra* note 22, at 565-66.

<sup>24</sup> *Eccles v. Sylvester*, 131 Colo. 296, 281 P.2d 1006 (1955). *Contra*, *Western States Life Ins. Co. v. Lockwood*, 166 Cal. 185, 135 P. 496 (1913) (president of a corporation must account for secret profits that he obtained).

<sup>25</sup> N. LATTIN, *THE LAW OF CORPORATIONS* 245 (1959); Note, *Corporations—Liability of Corporate Directors for Failure to Exercise Reasonable Diligence and Due Care*, 71 DICK. L. REV. 668, 673-74 (1967). See *Barnes v. Andrews*, 298 F. 614, 616-17 (S.D.N.Y. 1924) for an example of an insuperable burden of proof.

<sup>26</sup> *DePinto v. Provident Security Life Ins. Co.*, 374 F.2d 37 (9th Cir. 1967).

<sup>27</sup> *DePinto v. Landoe*, 411 F.2d 297, 301 (9th Cir. 1969).

*Ferrell*,<sup>28</sup> in which an invitee sued Busy Bee for injuries sustained when he fell through a trap door on the premises of the corporation. Busy Bee filed a cross-complaint for indemnity against its co-tenant, who had negligently left the trap door in a dangerous position. The court held that since the corporation's negligence had been passive, indemnity would be allowed; no injury would have occurred but for the active negligence of the co-tenant.<sup>29</sup>

The court's reliance on *Busy Bee* was misplaced. That case should have no effect on *Landoe* because the standard of care imposed in *Busy Bee* is not logically applicable to the situation involving negligence by a corporate director in carrying out his duties. Busy Bee recovered because the active negligence of the co-tenant caused the breach by the corporation of its duty to maintain a safe passage for invitees. The duty of DePinto, a corporate director, was to manage the assets of the corporation; he breached his fiduciary duty by failing to attempt to prevent the transfer of United's assets to American.<sup>30</sup> The standard of care required of Busy Bee was that it use *ordinary care* to prevent dangerous conditions on its premises. Directors of corporations, on the other hand, are fiduciaries required to exert the *utmost care and good faith* to protect the assets of the corporation.<sup>31</sup> Since only ordinary care was required of Busy Bee, it could recover indemnity because its negligence was passive when compared to the active negligence of its co-tenant. According to this logic, if the standard of care for a corporate director is higher than ordinary care, then not only would he be liable to the injured party for either active or passive negligence, as was Busy Bee, but he would also

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<sup>28</sup> 82 Ariz. 192, 310 P.2d 817 (1957).

<sup>29</sup> *Id.* at 197, 310 P.2d at 820-21.

<sup>30</sup> 411 F.2d at 300.

<sup>31</sup> *Norway-Pleasant Tel. Co. v. Tuntland*, 68 S.D. 441, 3 N.W.2d 882 (1942). In *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), the court applied different standards of care to various defendants based on the relationship of each particular one to the corporation. For example, the court applied a stricter standard of care to an attorney-director who helped prepare the corporation's registration statement than to a director who had no part in preparing the statement. *Folk, Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 42 (1969). Since *BarChris* arose out of violations of the Securities Act of 1933, the Act should govern the standard of care to be applied. The standard imposed by the Act is that "required of a prudent man in the management of his own property." 15 U.S.C. § 77(k)(c) (1964). This standard is equivalent to the high degree of care required by common law for fiduciaries. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); *Folk, supra* at 117. Thus, although the court in *BarChris* applied variable standards, it is clear that the Act requires a minimum standard of care that is equivalent to the high standard required of fiduciaries.

be unable to recover indemnity. Thus, active and passive negligence, which might be unequal under the standard of *Busy Bee*, should be found to be equal under the fiduciary standard with the result that the passive wrongdoer would not recover indemnity.

The decision in *Landoe*, if sound at all, could better have been based on equitable considerations that the court failed to enumerate. Whether to allow the equitable remedy of subrogation<sup>32</sup> should have been dependent upon the court's policy toward allowing indemnity for a corporate director who is passively negligent. In favor of allowing indemnity are: (1) the unfairness of permitting liability to fall on the director charged with passive negligence rather than the ones who are guilty of malfeasance and (2) the possible discouragement of some persons from assuming the responsibilities of corporate directors unless liability is limited to cases of malfeasance.<sup>33</sup> Militating against indemnity is the policy of protecting corporate stockholders. If the court had disallowed indemnity for the director who had been passively negligent, the effect would have been to encourage a higher standard of care of corporate directors and thus possibly to provide more protection for stockholders.

In deciding whether the court that decided *Landoe* reached the right result, it is necessary to consider how the above policies apply to the various relationships between co-directors. A paradigm used by Professor Scott in analyzing trusts is valuable in this analysis:

Where there are two trustees and a breach of trust is committed by one of them, the other is liable if he is himself guilty of a violation of duty to the beneficiaries. This is the case (1) where he participates in the breach of trust . . . (3) where by his failure to exercise reasonable care he has enabled his co-trustee to commit the breach of trust; (4) where he approves or acquiesces in or conceals the breach of trust. . . .<sup>34</sup>

Under Professor Scott's first category, a corporate director who participates in the breach of trust should be equally liable with the other participating directors. In *Knox Glass Bottle Co. v. Underwood*,<sup>35</sup> the

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<sup>32</sup> Subrogation is "founded on principles of justice and equity, and . . . [i]t rests on the principle that substantial justice should be attained regardless of form." *Castleman Constr. Co. v. Pennington*, — Tenn. —, —, 432 S.W.2d 669, 674 (1968); *accord*, *South Shore Nat'l Bank v. Donner*, 104 N.J. Super. 169, 249 A.2d 25 (1969).

<sup>33</sup> Note, *Position of Corporate Directors as Sui Generis*, *supra* note 22.

<sup>34</sup> 3 A. SCOTT, TRUSTS § 224 (1967).

<sup>35</sup> 228 Miss. 699, 89 So. 2d 799 (1956).

defendant-directors and their friends leased equipment to Knox at exorbitant rates. The directors were found jointly and severally liable for each other's gains and for the gains of their friends.<sup>36</sup> Joint participation represents the strongest case for joint and several liability among corporate directors, and, conversely, the weakest case for indemnity.

A trustee or director may be liable if, as in Professor Scott's fourth illustration pertaining to trustees, he approves, acquiesces in, or conceals the breach of trust even though he receives no benefit from the transaction. It is arguable that the facts of *Landoe* fall within this classification. Since DePinto's resignation from the board of United was tendered at the same meeting in which the resolution in question was passed, it is clear not only that he had actual knowledge of the intended transaction, but also that he was in a position to resist if he had not resigned.<sup>37</sup> His resignation, therefore, might be termed acquiescence or approval of the transaction. This situation represents a somewhat stronger case for indemnity due to a difference in the degree of fault between the director who was passively negligent and those who were guilty of malfeasance.

By analogy to Professor Scott's category number three, a director is liable if his failure to exercise reasonable care enables a co-director to commit a breach of trust. In *Allied Freightways, Inc. v. Cholfn*,<sup>38</sup> the wife of the corporation's president, who was a completely innocent and passive director, was unable to avoid liability for the wrongful conduct of the other corporate directors. In *Globus v. Law Research Service, Inc.*,<sup>39</sup> a cross-complaint for indemnity by a passively negligent underwriter against "active wrongdoers" was denied.<sup>40</sup> Although *Landoe* was based on state law and *Globus* was based on federal securities regulations, the Ninth Circuit in deciding *Landoe* should have examined the policy considerations that were stated in *Globus*:

This court believes that it would be against the public policy embodied in the federal securities legislation to permit [cross-complainant] which has been found guilty of misconduct in violation of the public interest involving actual knowledge of false and misleading statements or omissions and wanton indifference to . . . the rights of others, to

<sup>36</sup> *Id.* at 769-70, 89 So. 2d at 824. See *Beard v. Achenbach Mem. Hosp. Ass'n*, 170 F.2d 859 (10th Cir. 1948); *McGinnis v. Corporation Funding & Fin. Co.*, 8 F.2d 532 (M.D. Pa. 1925).

<sup>37</sup> 374 F.2d at 37.

<sup>38</sup> 325 Mass. 630, 91 N.E.2d 765 (1950).

<sup>39</sup> 287 F. Supp. 188 (S.D.N.Y. 1968), *rev'd on other grounds*, 418 F.2d 1276 (2d Cir. 1969).

<sup>40</sup> *Id.* at 198-99.



enforce its indemnification agreement. The purpose of the federal securities acts is to insure that the public investor . . . will obtain the benefit of a thorough investigation of the facts . . . not only by the issuer but also by the underwriter so that prospective investors will have access to the truth.<sup>41</sup>

*Globus*, far from being established law, is a landmark case indicating a trend toward protection of stockholders.<sup>42</sup> The court that decided *Globus* limited its holding to "circumstances where [the cross-complainant for indemnity] has been found guilty of misconduct evincing actual knowledge or reckless disregard of the falsity of the offering circular."<sup>43</sup> Since the cross-claimant in *Landoe* had knowledge of the intended transactions,<sup>44</sup> the case appears to be analogous to the limited factual pattern of *Globus*. *Globus* might be distinguished because the issue in that case involved indemnity for underwriters. However, the court in *Globus* found no significance in the distinction between underwriters and corporate directors.<sup>45</sup> The policies that affect directors were found to be equally applicable to underwriters: "If an underwriter were to be permitted to escape liability for its own misconduct by obtaining indemnity from the issuers, it would have less of an incentive to conduct a thorough investigation and to be truthful. . . ."<sup>46</sup>

In *Landoe*, the court, relying on the distinction between active and passive wrongdoers and on an analogy to the law of trusts, allowed the passive wrongdoer to recover indemnity. But the court entirely failed to consider the policy of protecting stockholders of corporations. That policy, which led to denial of indemnity for underwriters in *Globus*, is no less operative in the case of corporate directors. A stricter standard of care for corporate directors to promote greater protection of shareholders is necessary because of the enormous growth in number and size of corporations.<sup>47</sup> In huge, diversified corporations, most shareholders are completely unable to exert any control; and vigilance on the part of the directors in protecting the interests of all owners of stock becomes crucial.

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<sup>41</sup> *Id.* at 199.

<sup>42</sup> Knox, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in Light of BarChris and Globus*, 24 BUS. LAWYER 681, 692 (1969).

<sup>43</sup> 287 F. Supp. at 199.

<sup>44</sup> See p. 961 *supra*.

<sup>45</sup> Knox, *supra* note 42, at 690.

<sup>46</sup> 287 F. Supp. at 199.

<sup>47</sup> Snow, *Liability of Directors and Officers of Corporations*, 17 DEFENSE LAW J. 521 (1968).

Denial of indemnity should tend to motivate each director to police the actions of the other directors out of self-interest. In an age of super-corporations, the policy favoring a knowing, passive director over a knowing, active one weighs lightly in comparison to the policy of protecting shareholders. For this reason, the court in *Landoe* reached a questionable result by allowing recovery of indemnification by the passive corporate director.

RICHARD L. GRIER

### Federal Jurisdiction—Suits by a State as Parens Patriae

Although the right of a state to bring suit in a federal court was expressly provided for in the Constitution,<sup>1</sup> a state, in order to have standing, must have a sufficient interest in the outcome of the litigation.<sup>2</sup> Basically, the types of cases in which a state has capacity to sue have been classified as proprietary suits<sup>3</sup> and *parens patriae* suits.<sup>4</sup> Suing in each capacity, the State of Hawaii recently filed an antitrust action, *Hawaii v. Standard Oil Co.*,<sup>5</sup> in a United States district court against three oil companies and an asphalt company. Realizing the importance of its de-

<sup>1</sup> U.S. CONST. art. III, § 2, extends the judicial power of the United States to cases "between a State and Citizens of another State," and provides that in cases "in which a State shall be a Party, the supreme Court shall have original Jurisdiction." Suits by one state against another are within the original and exclusive jurisdiction of the Supreme Court. 28 U.S.C. § 1251(a)(1) (1964). Suits by a state against the citizens of another state are in the original, but not the exclusive, jurisdiction of the Supreme Court. 28 U.S.C. § 1251(b)(3) (1964).

Concepts of justiciability presumably apply equally to suits brought originally in the Supreme Court and in a lower federal court; however, it may well be that the Supreme Court, conscious of its caseload (*e.g.*, *Oklahoma ex rel. Johnson v. Cook*, 304 U.S. 387, 396 (1938)), would apply different standards of justiciability when jurisdiction by a lower court is available. *But see Georgia v. Pennsylvania R.R.*, 324 U.S. 439, 451-52 (1945).

<sup>2</sup> *E.g.*, *Florida v. Anderson*, 91 U.S. 667, 675-76 (1875). It is difficult to determine from the cases to what extent standing is grounded in constitutional mandate and to what extent in judicial policy. Clear-cut rules in the area are difficult to find because "[t]his complicated speciality of federal jurisdiction . . . is in any event more or less determined by the specific circumstances of individual situations . . ." *United States ex rel. Chapman v. Federal Power Comm'n*, 345 U.S. 153, 156 (1953).

<sup>3</sup> *E.g.*, *Virginia v. West Virginia*, 246 U.S. 565 (1918) (suit on a debt).

<sup>4</sup> *E.g.*, *Missouri v. Illinois*, 180 U.S. 208 (1901) (suit to enjoin the discharge of sewage into interstate river).

<sup>5</sup> 301 F. Supp. 982 (D. Hawaii 1969). Hawaii sued under sections 1 and 2 of the Sherman Anti-Trust Act, 15 U.S.C. §§ 1, 2 (1964) and section 4 of the Clayton Act, 15 U.S.C. § 15 (1964).